Caution: Deferred Compensation Loans Could be Dangerous

It’s so simple, perhaps too simple. You need some quick cash because of a financial emergency and you decide to borrow from your deferred compensation account. After all, it's your money and the interest and principal you pay goes back into your account. But as with most financial issues, it's not as simple as it sounds.

In fact, for most people, borrowing from their deferred compensation plan is not the best solution.

The rules:

You can borrow up to 50% of your account balance or $50,000, whichever is less. You usually have a maximum of five years to repay the loan, unless you are borrowing for a first home, which allows a longer payback.

There is one important factor to note before we get into the pros and cons: **If you’ve got a financial hardship that does not meet the IRS hardship qualifications borrowing may be your best alternative.**

Now, let’s go through the pros and cons of borrowing from your deferred compensation.

Pros:

1. **There is no credit check**. You don’t have to apply for the loan, and you can make plans knowing that you will get the loan.
2. **There is a low interest rate**. You pay the rate set by the plan; San Jose’s rate is the Moody’s Corporate Bond Yield Average.
3. **It provides a reasonable return**. Since you pay yourself the interest, it looks like a good deal.
4. **The interest is tax-sheltered**. You don’t have to pay taxes on the interest until retirement, when you take money out of the plan.
5. **It’s convenient**. You only have to make a phone call.

Cons:

1. **You pay more taxes**. Since you repay the loan with after tax dollars the interest is double taxed. Significantly increasing the cost of borrowing.
2. **There are consequences if you leave your job**. If you leave your job the loan is due and payable or it will become taxable income in that year. (Any rolled over assets from non-governmental plans remain subject to the IRS 10% premature withdrawal penalty tax if withdrawals are taken prior to age 59½.)
3. **You’re losing interest**. The net effect is that you have less money to invest and to earn interest. The money you borrow – or take out – of your retirement plan no longer appreciates in value from interest, dividends and/or capital gains in conjunction with the rest of your investment portfolio.
4. **Can you afford to substantially increase your contributions**? – Probably not. As a result of having to make loan repayments, you’ll probably have to reduce the amount you contribute, further reducing the amount you will have at retirement.
5. **The loan isn’t tax deductible**. The loan isn’t tax deductible. It’s considered a consumer loan, so there is no tax advantage.
6. **It affects your psychology toward retirement saving**. If possible, your retirement money should sit untouched until you retire. It’s too easy to get in the habit of dipping into your deferred compensation instead of saving for things you need along the way. Keep your deferred compensation in a loan free zone.

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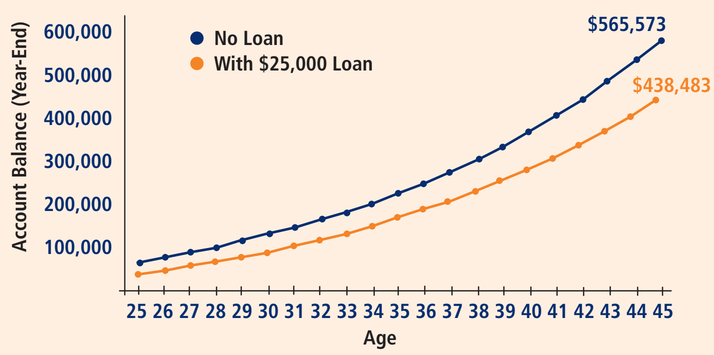
The following example illustrates how taking a loan from deferred compensation plan account could impact your future account balance over 20 years. Based on the assumptions in the example below, taking a $25,000 loan could cost you $127,090.

Effect of Taking a Loan



Assumptions:

- Current Account balance is $50,000. Loan decreases beginning account balance to $25,000. Annual account contributions are $6,000.
- Annual rate of return is 8%. Borrowing rate is 7%.
- Annual loan repayment at 7% rate is $5,940 for five years. In order to stay cash flow neutral, participant stops regular contributions for five years

The bottom line:

Consider other possible sources of accessible assets before tapping into the deferred compensation plan. Remember, a loan may or may not reduce your overall account value and repayment may or may not help restore the growth potential of your account depending upon a number of factors, including: the rate as compared to the underlying rate of return those assets would have earned had a loan never been taken in the first place; stock market fluctuations; timing of loan repayments; and other variables.

IMPORTANT INFORMATION

Group annuities are long-term investments designed for retirement purposes. Money taken from the annuity will be taxed as ordinary income in the year the money is distributed. Account values fluctuate with market conditions, and when surrendered the principal may be worth more or less than its original amount invested. An annuity does not provide any additional tax deferral benefit, as tax deferral is provided by the plan. Annuities may be subject to additional fees and expenses to which other tax-qualified funding vehicles may not be subject. However, an annuity does provide other features and benefits, such as lifetime income payments and death benefits, which may be valuable to you.

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